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No. 87-1793

IN THE

Supreme Court of the United States

OCTOBER TERM 1987

In the Matter of

READING COMPANY,

Petitioner,

v.

CJI INDUSTRIES, INC.,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals For The Third Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the Court of Appeals properly concluded that the lower court, supervising a reorganization under Section 77 of the former Bankruptcy Act, had abused its discretion in allowing a setoff under the circumstances presented.

DESIGNATION OF CORPORATE RELATIONSHIPS

CJI Industries, Inc., is not owned by any parent corporation. CJI has a majority voting ownership in Triangle Industries, Inc. CJI has a majority ownership interest in the Dover & Rockaway Railroad Company. CJI does not have an ownership interest in any other subsidiaries (excepting only wholly owned subsidiaries).

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RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondent respectfully submits that this Court should deny the petition for writ of certiorari. The petition seeks review of the opinion issued in this case by the United States Court of Appeals for the Third Circuit. The opinion is reported at 838 F.2d 686 (3rd Cir. 1988).

STATEMENT OF CASE

The Central Railroad Company of New Jersey (CNJ) was a New Jersey railroad which commenced reorganization proceedings under Section 77 of the former Bankruptcy Act (11 U.S.C. § 205) in March of 1967. In April of 1976, CNJ conveyed its active rail properties to Consolidated Rail Corporation (Conrail) pursuant to the Regional Rail Reorganization Act of 1973, as amended, (the Rail Act) (45 U.S.C. §§701, et seq.). Further reorganization proceedings were continued pursuant to § 601(b)(4) of the Rail Act (45 U.S.C. § 791(b)(4)); and in September of 1979 Central Jersey Industries, Inc. emerged as the reorganized company of CNJ's non-rail assets. Respondent, CJI Industries, Inc., (CJI) is the successor to Central Jersey Industries, Inc.

When CNJ went into reorganization in March of 1967, it owed substantial sums to interline claimants, including $971,710.59 to petitioner, Reading Company (Reading). It also owed an additional $77,744.11 to Reading on various non-interline pre-bankruptcy obligations. After the Third Circuit held that freight interline balances were trust funds and not simply debt obligations, *In Re Penn Central Transportation Company*, 486 F.2d 519 (3rd Cir. 1973), CNJ's trustee entered into a settlement with the Committee of Interline Railroads which provided a framework for disposing of all pre-bankruptcy interline claims asserted against CNJ by railroads accepting the terms of the settlement. The settlement agreement provided that the net interline balances owed by CNJ to accepting railroads would be satisfied by (a) prompt cash installment payments of 35% of the amount owing, (b) an acknowledgement of 25% of the amount owing as ordinary administration expense, and (c) treatment of the remaining 40% of the amount owing as unsecured debt of CNJ.

In 1978 Reading, which had gone into reorganization under Section 77 in 1971, accepted the CNJ interline settlement agreement after receiving authority from its own reorganization court; and Reading thereafter received the 35% cash payment as well as the distributions made under CNJ's reorganization plan

to ordinary administration claims for 25% of the amount owing. In July of 1979, Reading filed in the CNJ proceeding an unsecured proof of claim for $466,428.35, which was the sum of the $388,684.24 of the agreed 40% unsecured portion of its interline claim and the additional $77,744.11 pre-bankruptcy debt owed by the CNJ to the Reading. Reading never indicated during the course of its acceptance of the interline settlement agreement or at any other time during the CNJ reorganization proceeding that Reading claimed an entitlement to set off its unsecured claim against CNJ against monies it owed to CNJ.

CNJ's amended plan of reorganization was considered by its creditors and shareholders in the summer of 1979. A detailed description of the plan and the problems which it sought to solve are set forth at *In Re The Central Railroad Company of New Jersey*, 473 F. Supp. 225 (D.N.J. 1979). Reading, which had actively participated as a party intervenor in CNJ's reorganization proceedings from its inception, opposed the entry of the approval, consummation and confirmation orders with respect to the plan. It filed appeals from each of these orders; and the orders were affirmed at Appeal Nos. 79-1961, 79-2195 and 80-1001, Third Circuit, 1/8/80.

The circumstances of the CNJ were particularly dire at the time of its reorganization. The estate was confronted with over $160 million in liabilities; about $70 million of the liabilities consisted of post-bankruptcy administration claims; and over $80 million consisted of pre-bankruptcy secured debt owed on mortgage bonds held by the public and secured notes held by the U.S. government, 473 F. Supp. at 227. The only assets the estate had to meet those obligations were $30 million in cash, real estate valued at $15-30 million and certain claims of indeterminate value which would take years to litigate, 473 F. Supp. at 226, 227. Of principal significance was the claim asserted in the valuation case for compensation for the rail assets transferred to Conrail by CNJ under the Rail Act. CNJ claimed that approximately $100 million was owing on this claim and the government claimed that approximately $8.8 million was owing. The reorganization plan stated:

> "The size of the recovery in the valuation case pending in the Special Court is uncertain and can not be determined in this proceeding.

> If it is very large, many claimants should receive payment on their claims. If it is very small, few should receive anything. The Amended Plan preserves the rights of all until the size is known. It establishes a number of contingent interests in the recovery which will share according to designated priorities. Those contingent interests include certain administration claims (*e.g.*, a portion of the § 211(h) claims, tax claims and the expense of taking down the Newark Bay Bridge); portions of the claims of secured creditors; and all of the claims of unsecured creditors and present stockholders."

The CNJ reorganization plan addressed these dire circumstances by providing for (i) the delivery of all the stock of the reorganized company to the pre-bankruptcy secured creditors in exchange for 50% of the principal owing to them on the secured debt and (ii) the dedication of the valuation claim in trust to CJI to be prosecuted for the benefit of unpaid claimants who were to exchange their claims for various series of contingent, non-recourse securities reflecting interests in future valuation proceeds according to established priorities. Unsecured creditors, such as Reading, were entitled to receive Series I Notes. While the security was called a "note", it reflected no indebtedness but was simply evidence of an interest in the valuation case proceeds, when, as and if they were received in an amount sufficient to redeem the security.

The CNJ reorganization was consummated in mid-September 1979. The unsecured debt owed by CNJ to Reading, reflected in Reading's $466,428.35 proof of claim, was satisfied by the provisions of the plan making the Series I Notes available to Reading. The assets of the debtor, which included CNJ's claim against the Reading discussed below, were vested in the reorganized company "free and clear of all claims, rights, demands, interests, liens and encumbrances of every kind and character"; and the debtor and its trustee were discharged from all debts and liabilities previously owing.

The Reading filed its petition for reorganization under §77 in November of 1971. In September of 1972, CNJ submitted its

proof of claim against Reading for unsecured pre-bankruptcy indebtedness. The amount of such debt has been stipulated at $497,945.52. CNJ did not otherwise participate in the Reading reorganization proceedings.

Reading was reorganized on January 1, 1981. Its circumstances were not nearly as dire as CNJ's; for provision was made to pay all of its creditors in full and to return the equity of the reorganized Reading to the previous shareholders of the debtor. Under the Reading plan of reorganization, respondent, as a successor to CNJ, was entitled to receive an unsecured creditor note of $497,945.52. When respondent sought to obtain its entitlement under the Reading plan, Reading asserted a setoff of the $466,428.35 which CNJ had owed the Reading before the consummation of the CNJ reorganization plan. Respondent then filed a petition, on June 6, 1982, in the Reading reorganization court, seeking an order directing Reading to pay respondent's claim in accordance with Reading's plan of reorganization.

A hearing was held on the petition on April 7, 1983. The reorganization court delayed nearly four years in issuing its opinion resolving the dispute. While the value of the Series I Note was indeterminate at the time of the submission of the case to the court (and the parties stipulated that "it is presently unknown if and when any payment will be made on the CJI Series I Notes"); during the intervening period, it became clear that the I Notes would have no value. Specifically, a final judgment was entered on CNJ's claim for compensation in the valuation case *In the Matter of the Valuation Proceedings Under §§ 303(c) and 306 of the Regional Rail Reorganization Act of 1973*, 591 F. Supp. 651 (Spec. Ct. RRRA, 1984), aff'd sub nom **CJI v. USRA**, 496 U.S. 1100 (1985). The valuation proceeds payable under the judgment were sufficient to redeem the notes issued for administration claims and to make a substantial payment on the F Notes which had been issued to the pre-bankruptcy secured creditors for the interest owing on their debt. The balance of the F Notes were left unpaid; nothing was paid on the H Notes issued for 50% of the principal owing to the secured creditors; and nothing was paid on the I Notes issued to unsecured creditors or on the Certificates of Contingent Interest issued to CNJ's former shareholders.

The Reading reorganization court denied respondent's application and allowed Reading to set off the amount that CNJ had formerly owed the Reading against the amount that Reading owed respondent. The effect of the order was (i) to permit Reading to obtain payment in full of its former unsecured claim against CNJ (even though a substantial portion of the claims of CNJ's secured creditors were unpaid as were the claims of all other unsecured creditors of CNJ) and (ii) to deny respondent payment of its claim against the Reading (even though all other creditors of the Reading were paid in full and the Reading shareholders received distributions under the Reading plan).

On appeal, the United States Court of Appeals for the Third Circuit (Third Circuit) reversed, holding that the District Court had abused its equitable discretion by allowing the setoff under the facts presented.

REASONS FOR DENYING THE PETITION

The Third Circuit decided only a narrow question of negligible significance to current law. The decision is not in conflict with any decision of this Court or any other appellate court; and the decision is clearly correct.

A. There Are No Special And Important Reasons Presented To Justify Review On Writ Of Certiorari

Rule 17.1 of the Rules of this Court provides that review on writ of certiorari "will be granted only when there are special and important reasons therefor". The petition fails to demonstrate any such "special and important reasons". It does not claim that the Third Circuit's decision is "in conflict with the decision of another federal court of appeals on the same matter" or "with a state court of last resort"; nor does it claim that the Third Circuit "has so far departed from the accepted and usual course of judicial proceedings. . . as to call for an exercise of this Court's power of supervision". While it is claimed that the Third Circuit erred in believing that the ruling in *Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467 (1974) has application to the present case, the petition does not claim that the Third Circuit decision has decided an important question of federal law "in a way in conflict with applicable decisions of this Court". Perhaps Read-

ing's contention is that the Third Circuit has decided an important question of federal law which "should be settled by this Court".

It is hard to plausibly argue that questions as to the limits or meaning of *Baker* are still important ones of federal law that should be settled by this Court. *Baker* addressed the questions of whether the setoff provisions of Section 68 of the former Bankruptcy Act, 11 U.S.C. §108, applied to railroad reorganizations under Section 77 and concluded that it did not. The Bankruptcy Act, along with the unique provisions of Section 77, was repealed prospectively almost ten years ago and replaced by a substantially revised statutory scheme. It is unlikely that any railroad reorganization proceeding under Section 77 (or under that Section and §601(b)(4) of the Rail Act) is still pending; and even if there are any, it is extremely unlikely that a review in the instant case would clarify the law with respect to any live issue in those proceedings. Since the Third Circuit decision is principally concerned with the meaning and application of *Baker*, it does not involve "an important question of federal law which . . . should be settled by this court".

Petitioner seeks to escape the limited significance of the issue decided below by posing an abstract question for review, formulated without regard to any particular statute. The question it poses is

> "Whether a court of appeals improperly circumscribes the discretion of a district court, sitting in bankruptcy, when it holds that the district court cannot allow a debtor to assert a prebankruptcy claim as a setoff against a prebankruptcy debt in making distribution under the debtor's reorganization plan".

The question is defective not only because it ignores the specific issues addressed by the Third Circuit, but also because it misstates the Third Circuit's holding. The Third Circuit expressly declined to hold that the District Court lacked discretion to allow a debtor to assert a setoff but instead determined that, if the District Court had such discretion under Section 77, it had improperly exercised it in light of the facts presented. Certainly the issue of whether the District Court abused its discretion in light of the circumstances before it is not "an important

question of federal law which . . . should be settled by this court". The petition should be denied because it presents no special and important reasons to justify review.

B. **The Decision Of The Third Circuit Was Correct**

While the Third Circuit could have decided "that the presumption against setoff announced in *Baker* amounts to an absolute prohibition", it "declined the invitation to so hold in this case" (11a). Instead, it assumed discretion in the reorganization court and found "that Reading simply has not demonstrated the existence of equitable considerations compelling enough to necessitate further inquiry" (11a).

Reading had urged, in support of the setoff, the fact that neither party was a railroad any longer and the argument that debtor setoffs should be treated differently from the creditor setoffs involved in *Baker*. The Third Circuit properly disposed of both points. It found that §601(b)(4) of the Rail Act continued the applicability of §77 legal principles to the estates choosing to reorganize thereunder (even though they no longer operated railroads); a result which Congress authorized to avoid the potential unfairness of changing in midstream "the rules of the game" applicable to the pending reorganization proceedings affected by the Rail Act. The Third Circuit went on to find that "the Supreme Court's concern in *Baker* that setoff would violate the fair and equitable requirement, 417 U.S. at 473-4, is fully applicable here" because allowing the debtor setoff treated "CJI less favorably than Reading's other unsecured creditors" (12a). In fact, all other Reading creditors were paid in full and the shareholders of the debtor received the common stock of the reorganized Reading.

Petitioner, claiming that respondent was receiving "a windfall double recovery", takes issue here with the Third Circuit's application of *Baker*, characterizing it as "nothing short of bizarre". What is bizarre is petitioner's analysis.

In the CNJ reorganization, Reading received the right to a Series I Note security which was the full and fair equivalent of Reading's claim against the CNJ. The lack of any ultimate return on such security was simply the proper and legal consequence of the relative poverty of the CNJ estate — a conse-

quence which all other unsecured creditors and even secured creditors of CNJ have had to endure. Allowing the setoff would have the effect of preferring Reading's claim against the CNJ over the claims of others who had equal or higher priority. On the other hand, since the Reading estate was solvent, CJI was entitled to have its claim paid in full. It was not unfair or inequitable for Reading to pay full value on its debt (where all its creditors received such value) even though Reading received no ultimate recovery on its claim against the CNJ estate (where the other unsecured creditors of CNJ experienced a similar disappointment). The "fair and equitable" standard governed the distribution of assets in the payment of claims within each estate and was not intended to control adjudication of disputes between estates or their successors.[1]

Moreover, the Reading reorganization court had failed to address the real equities shown by the stipulated record. While purporting to balance the equities, it ignored the single, most important, equitable circumstance before it — the fact that Reading, in accepting the interline settlement agreement with the prior approval of its reorganization court, voluntarily agreed to take its chances with all other similarly situated railroads to be compensated for 40% of its interline claim on an equal basis with the other unsecured creditors of CNJ. In consideration for this agreement, Reading received a prompt payment of 35% of its claim and an entitlement to administration claim status on 25% of its claim. If there were to be an attempted setoff, Reading should have declared its intentions when the deal was made in 1978 and, in any event, it should have raised the issue of its entitlement to a setoff in the CNJ reorganization proceeding during the course of the plan hearings in 1979, in which it played such a prominent and obstructive role. As the Third Circuit long ago stated in rejecting a purported setoff under Section 68 in *In Re Mauch Chunk Brewing Co.*, 131 F.2d 48 (3rd Cir., 1942):

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[1] Underlying petitioner's argument is the erroneous assumption that CJI continued, after the CNJ reorganization, to owe Reading the unsecured claim which CNJ had owed Reading. That assumption is erroneous because the prior unsecured claim was fully satisfied by the availability of the contingent non-recourse I Note. CJI never owed Reading any debt on the I Notes since valuation proceeds were never realized in an amount sufficient to reach the I Notes.

> "Section 68 of the Bankruptcy Act allows a creditor to set off, if certain conditions of that section are met, mutual debts existing between him and the debtor. This is a privilege which the creditor may or may not claim. If it is not asserted, it is lost. Likewise if the creditor's conduct is inconsistent with a subsequent claim of set off, he is held to have waived it." *Id.* at p. 49.

In addition to the issue actually decided, the result reached below can be upheld upon a number of alternative grounds. The Third Circuit, believing that *Baker* controlled the dispute, found it unnecessary to address the various alternative arguments urged by CNJ to demonstrate that the district court lacked any discretion to grant the setoff. Since Reading has addressed some of those arguments in its petition, we now respond.

One of our alternative arguments was that Reading was barred by *res judicata* from asserting a setoff. It had actively litigated the approval, confirmation and consummation orders entered by the CNJ reorganization court on the CNJ plan hearings. Those orders (i) provided for the satisfaction of Reading's claim against CNJ by the availability of the I Note security, (ii) transferred CNJ's claim against Reading to CJI "free and clear of all claims, rights, demands, interests, liens and encumbrances of every kind and character" and (iii) restrained everyone "from interfering with", "enforcing liens against", or "disturbing any portion of" the accounts receivable Reading owed to CJI. *Res judicata* applies to all matters litigated or that should have been litigated; and the doctrine barred Reading's alleged rights of setoff.

Second, the setoff was improper because there were no mutual debts or credits, within the meaning of former Section 68, to set off. The origins of CNJ's obligations to Reading were principally a trust fund and not a debt. More important, CJI was never obligated on any debt to Reading. The I Note was a contingent, non-recourse security, issued by CJI in its trustee capacity, not an unconditional promise to pay a certain sum. It only certified to an interest in a possible future fund which CJI might receive as a trustee of the valuation proceeds for the benefit of former CNJ creditors. No such proceeds had been received when CNJ's reorganization plan was consummated in 1979, when Reading's reorganization plan was consummated in 1981,

when the setoff was allegedly taken in 1982, or when the dispute was fully submitted to the lower court in 1983; and it was unknown at all of those times when the proceeds would be received and in what amounts. As it turned out, the valuation case was resolved in late 1984 and insufficient funds were realized to make any payment at all on the I Notes. Since there was no debt owing to the Reading at any pertinent time, there was nothing to set off. See *Collier on Bankruptcy*, (14th ed. 1978, vol. 4 at pp. 861, 867-8, and 872-3); and *In the Matter of Autler*, 23 F. Supp. 756 (S.D.N.Y. 1938).

Finally, we contended that Reading was wrong in its basic position that discharged debts can be used for defensive setoffs. Even in a liquidation setting, the law does not permit the setoff of discharged debts as a defense to an action on a mutual debt. The Reading reorganization court thought to the contrary, relying principally on *Krajci v. Mt. Vernon Consumer Discount Co.*, 16 Bankr. 464 (E.D. Pa. 1981), a case which was incorrectly decided [2] and which has no applicability to the within controversy. See *Collier on Bankruptcy*, (14th. ed. 1978, vol. 6A, at pp. 300-02). *Krajci* was a straight liquidation case decided under the Bankruptcy Code. The effect of a discharge under the Code is controlled by 11 U.S.C. §524, a section which the opinion in *Krajci* overlooked, and which explicitly prohibits the offset of any debt that has been discharged.

Section 524(a)(2) provides:

> "(a) A discharge in a case under this title...
> (2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, *recover or offset any such debt* as a personal liability of the debtor, or from property of the debtor..." (emphasis added)

The legislative history to §524(a) appearing in H.R. Rep. No. 595, 95th Cong., 1st Sess. at 365-6 notes:

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[2] The court in *Krajci* relied on *Binnick v. Avco Financial Services*, 435 F. Supp. 359 (D. Neb. 1977), decided under Section 14(f) of the former Bankruptcy Act, 11 U.S.C. §32(f), which Section 524(a)(2) of the Bankruptcy Code substantially amended. It is arguable that the defensive setoff of a discharged claim was permissible under Section 14(f). See *Ryan v. Ohio Edison Company*, 611 F.2d 1170 (6th Cir. 1979).

> "This paragraph has been expanded over a comparable provision in Bankruptcy Act § 14f [former section 32(f) of this title] to cover any act to collect, such as dunning by telephone or letter, or indirectly through friends, relatives, or employers, harassment, threats of repossession and the like . . . (The provision) is intended to insure that once a debt is discharged, the debtor will not be *pressured in any way* to repay it. In effect, *the discharge extinguishes the debt*, and creditors may not attempt to avoid that." (emphasis added)

Each of the three contentions discussed above, which were left unresolved by the Third Circuit, shows that the reorganization court erred as a matter of law in allowing the setoff; and they each provide additional support for the decision of the Third Circuit.

The determination of the Third Circuit was, therefore, clearly correct. No justifiable reason exists for further protracting this dispute and delaying respondent's recovery.

CONCLUSION

For all the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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